WORLD ECONOMY

FINANCIAL TIMES **SPECIAL REPORT** | Friday September 23 2011

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Financial institutions stare into the abyss

The need for concerted action is greater than ever, as imbalances across the eurozone are replicated globally, reports **Chris Giles**

The world economy once again stands on a precipice. Finance ministers might want to look straight ahead, but investors are forcing them to peer down to the abyss.

As advanced economies slow sharply and emerging economies wonder whether inflation or recession is the greater threat, the need for finance ministers to find a way to achieve their ambition of "strong, stable and balanced" global growth has rarely been more urgent.

A world expansion must be strong enough to allow adjustment to the stresses that have built in the past decade. It must be stable because any hitches risk an intensification of the crisis. And it must be balanced, because simply putting off the necessary restructuring will only increase the strains causing angst among investors and politicians.

The alternative is another financial and economic crisis, worse perhaps than that of 2008-09.

Those in positions of authority are worried. Christine Lagarde, the new managing director of the International Monetary Fund, has urged countries make necessary adjustments to restore confidence.

"I believe there is a path to recovery, much narrower than before, and getting narrower. To navigate it, we need strong political will across the world leadership over brinkmanship, co-operation over competition, action over reaction," she said in a speech this month.

Tim Geithner, the US treasury secretary, flew to Poland this month with the same message to European finance ministers that the time has come for political will to solve the eurozone crisis and help put the world economy on a stronger footing.

"Governments and central banks have to take out the catastrophic risks from markets . . . [and avoid] loose talk about dismantling the institutions of the euro," he said.

The scene is set for the discussions at the Group of 20 and the International Monetary Fund this weekend to be as tense as those in 2008.

Then, the post-Lehman economic crisis and deep recession were stemmed by a huge show of force from global policymaking. Governments underwrote their banking systems. Interest rates across the advanced world were cut to negligible levels. Central banks turned to unorthodox measures both to pump newly created money into their economies and ease strains in markets that had frozen.

Governments allowed tax revenues to plummet without offsetting action and implemented some stimulus. Commodity prices plunged, raising real incomes in oil-consuming nations. Emerging economies, particularly China, gave a huge boost to domestic investment with direct spending and looser restrictions on lending. And very few nations erected trade barriers to impede the recovery when it came in spring 2009.

The policies worked in stemming the crisis, but some have fallen into reverse. Commodity prices have risen to levels similar to those in 2008, the equivalent of a tax on oil-consuming countries. Fiscal policy is being tightened across the advanced world. But the greatest problem in advanced economies is that companies and households remain cautious about spending.

Companies are hoarding cash. Households are reducing liabilities and governments, particularly in the eurozone, are realising the limits of being the consumer of last resort. For them, the adjustment is far from complete.

Willem Buiter, chief economist of Citi, says: "The advanced economy slowdown is across the board and countries reinforce each other. We don't expect a recession yet – although we are close to it – but there is not enough growth likely to stop unemployment rising in the US."

Having revised their global economic forecasts higher as the recovery initially seemed better than expected, international organisations have become much more gloomy.

The Organisation for Economic Co-operation and Development expects almost no growth in advanced economies for the rest of 2011 and the latest figures from the International Monetary Fund this week mark down global economic growth in 2011 from 4.3 to 4 per cent, and from 4.5 to 4 per cent in 2012, with advanced economies facing the bulk of the forecast downgrade.

Rich countries no longer dominate the world economy. At market exchange rates some 40 per cent of global output comes from emerging economies and a much greater share of growth. On the basis of the IMF's spring forecasts, the combined size of emerging economies would expand 30 per cent between 2007 and 2012, an average annual growth rate of 6 per cent. For advanced economies the growth rate over the same period is likely to be close to zero.

But becoming the dominant force in global growth has not helped emerging economies ride out the storm. Faced with twin threats of global downturn and inflation, policymakers have not known where to turn.

Some countries, Turkey and

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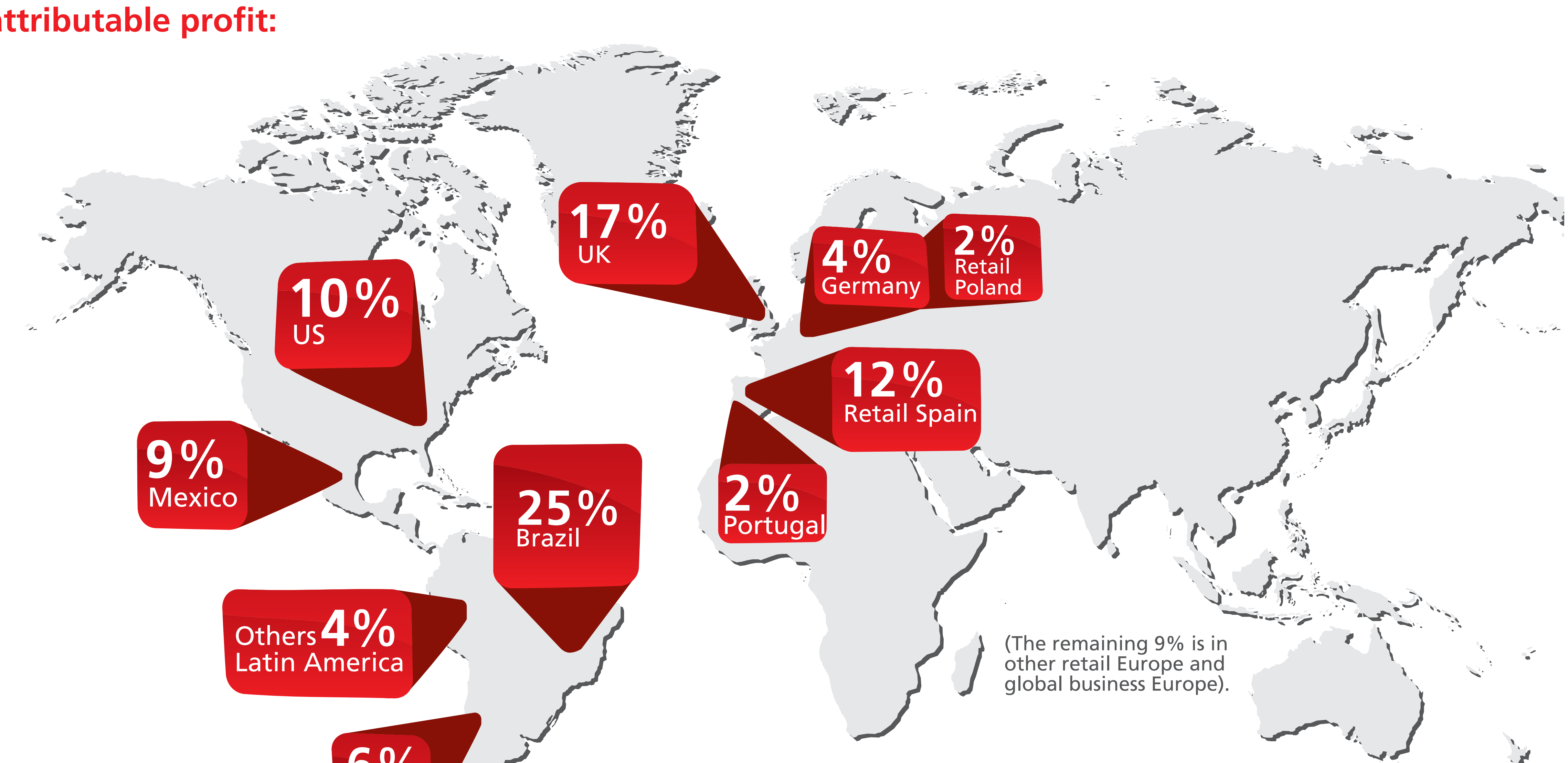
A STRONG GLOBAL BANK

Geographical distribution of first half 2011 recurring attributable profit:



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Debt crisis deepens on Greek default fears

Eurozone

The role of the central bank is under increased scrutiny, writes **Ralph Atkins**

For Jean-Claude Trichet there will be no gentle wind-down before his retirement. The eurozone debt crisis has assumed a punishing intensity in recent months, stretching the skills of even veterans of financial market crises such as the European Central Bank president.

As he prepares to step down on October 31, the future of Europe's monetary union remains unclear. Possibilities that even a few months appeared slim are no longer ruled out.

German politicians speculate openly about Greece defaulting or even leaving the eurozone. Financial markets fear a return of the paralysis that struck after the collapse of Lehman Brothers in late 2008.

Europe's economic integration could also be thrown into reverse. Conveying the drama of the moment, Angela Merkel, German chancellor, warned the Bundestag this month that the euro was more than just a currency. "The euro is a guarantor of a united Europe, or put it another way: if the euro fails, Europe fails."

For now, much lies in the hands of the ECB. With its theoretically unlimited firepower and ability to act rapidly, the ECB is the final backstop for the euro.

As broader worries emerge over the strength of eurozone banks – at a time when economic growth has stalled across the region – the ECB has become the sole institution capable of calming financial market nerves. But the resignation this month of Germany's Jürgen Stark from the ECB's executive board highlighted internal divisions over crisis management strategy, especially the ECB's controversial bond-buying programme.

Germany's conservatives fear the ECB's actions have undermined its independence by straying into fiscal policy, threatening its credibility and ultimately the battle against inflation.

A turning point came in July. The debt problems of Greece, which lay behind the original outbreak of the eurozone debt crisis, had intensified once more. Eurozone political leaders agreed that a fresh bail-out plan was needed, but Germany successfully led a push for private-sector banks to share some of the burden. Its principled point was that taxpayers should not foot the bill entirely, even though credit rating agencies warned any signs of coercion would result in Greece being deemed in default – and the ECB warned that it would send a disastrous signal to investors in other eurozone countries.

At their July 21 summit in Brussels, eurozone leaders insisted their plan for Greece would be "exceptional and unique". They also took other steps to alleviate its finance by slashing the interest rate payable on bail-out loans and extending their maturity. Similar help was given to Ireland and Portugal.

> The ECB has become the sole institution capable of calming financial market nerves

Nevertheless, investors took fright. By early August, the market borrowing costs of Italy and Spain were reaching worrying levels. The ECB faced a dilemma. It wanted Rome to take bold action to address the crisis but feared a financial meltdown.

After a tense weekend at what should have been the height of the holiday season, the government of Silvio Berlusconi announced a series of structural and fiscal reforms.

On Sunday August 7, Mr Trichet said the ECB would "actively implement" its bond buying. Within hours, it had started the large-scale buying of Italian bonds. Rome, however, has yet to convince markets of its commitment to reducing public debt; Italy's position as one of the eurozone's largest economies magnifies the significance of any perceived default risk.

Meanwhile, fears of a full-blown Greek default have escalated, and worries over sovereign debt holdings have fuelled fears about the financial strength of banks across the continent.

Eurozone governments, meanwhile, have yet to implement another step agreed on July 21 – boosting the powers of the European Financial Stability Facility, the bail-out mechanism set up a year ago.

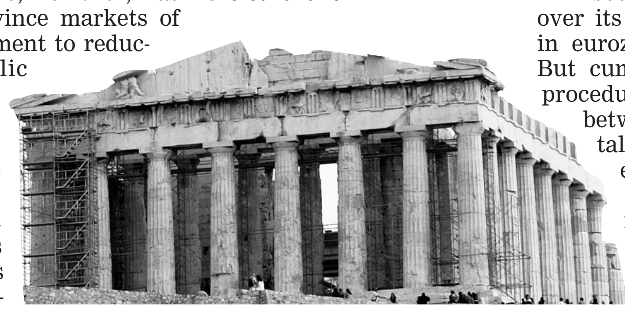
As well as supporting crisis-hit countries directly, the ECB is hoping the EFSF will soon be able to take over its role of intervening in eurozone bond markets. But cumbersome operating procedures and disputes between national capitals could hamper its effectiveness.

There are not many bright spots. Whereas Greece has failed to meet targets set under its international bail-out, Portugal's programme appears to be on track, and Ireland even shows signs of making a comeback, helped by export growth.

But overall, the eurozone economic recovery has stalled. In the second quarter, gross domestic product expanded by just 0.2 per cent compared with the previous three months.

Gloom about global prospects, including in the US, as well as fiscal austerity measures and eurozone debt woes have led to falls in business and consumer confidence. Forward-looking purchasing managers' indices hold out little hope of a growth rebound in the second half. Weaker growth will hit the banks further.

The ECB has so far averted disaster. As well as its large-scale bond purchases, it has continued to provide unlimited liquidity to eurozone banks. But it is proving to be a fateful autumn for the eurozone.



Crumbling empire: a united Europe is said to depend on Greece staying in the eurozone

GERMANY
Domestic growth slowdown a worry

The future of the eurozone, and the capacity of the 17-nation currency union to recover from the debt crisis among its peripheral members, depends on the performance of the German economy more than on any other in Europe.

Equally, Germany's prosperity is inextricably linked with the success and survival of the single currency, with more than 38 per cent of German exports going to its eurozone partners, and almost 58 per cent to the 27 members of the European Union. The stability of the euro has been a big factor in the remarkably swift recovery of the German economy from the economic crash of 2008-09.

Yet Angela Merkel, the German chancellor, is facing an struggle to persuade her electors, particularly her own supporters in the centre-right coalition, to provide the financial guarantees needed to tide over the most debt-laden eurozone members.

For the past 18 months, German economic growth has provided the impetus for its partners, but the rate of growth has slowed appreciably in recent months. After a 3.6 per cent rise in gross domestic product in 2010, and 1.3 per cent growth in the first quarter of 2011, the rate of increase slumped to 0.1 per cent in the second quarter of the year.

Bullish business expectations have also dropped off. The closely followed business climate index published by the Ifo institute in Munich dropped from 112.9 in July to 108.7 in August, as companies scaled back their expectations for the second half of the year.

Ms Merkel still believes that growth in the current year will be "closer to 3 per cent than 2.5", and most analysts expect a soft landing.

The chancellor's dilemma is how to persuade her voters they can afford to be more generous to their eurozone partners in the short term, in order to assure their continued growth in the long run. The worry for her partners is that slower German growth will not provide the stimulus they need to pull them out of recession.

Quentin Peel

FRANCE
Public spending a weak point

Nicolas Sarkozy, the characteristically hyperactive French president, repeatedly interrupted his August break to deal with the crisis engulfing the eurozone.

An emergency meeting of his cabinet and a Paris summit with Chancellor Angela Merkel were packed into the month as Mr Sarkozy attempted to persuade sceptical markets that the eurozone's political leadership was in command of the region's sovereign debt problems, that France's own public finances were under control and, not least, a fierce market assault on French banks was unmerited.

Mr Sarkozy has responded to the Greek crisis by throwing France firmly behind the eurozone's second bail-out plan for Athens agreed in July. France was the first eurozone member to ratify the plan. The president, in league with Ms Merkel, is leading a push for closer economic governance within the eurozone and regulatory action, such as reform of the rating agencies, in a bid to prevent a recurrence of the sovereign debt problems.

France's Achilles heel, however, is its public finances. Its debt is in excess of 80 per cent of GDP and the budget deficit this year is projected at 5.7 per cent of GDP.

Little surprise therefore, that, given the extra exposure France assumed to Greece under the July bail-out plan, financial markets put in question the country's triple-A rating when Standard & Poor's downgraded the US. The spread between French government bonds and German Bunds widened as a result and French bank shares took a dive.

Mr Sarkozy's government reacted by introducing a supplementary budget package, made up of a variety of tax measures worth €12bn ($16.5bn) over this year and next, to ensure the country remained on track to reduce the deficit to 4.5 per cent of GDP in 2012 and return to the eurozone's supposedly mandatory level of 3 per cent in 2013.

France's fiscal task is made harder by a slowing economy. Official projections are for growth of 1.75 per cent this year and the same in 2012.

Against this background, Mr Sarkozy's opponents on the left and right are queueing up to attack him over the economy. He faces a winter every bit as tough as his turbulent summer.

Hugh Carnegy

SPAIN
Prudence starts to pay off

In May last year, US president Barack Obama made a highly unusual telephone call to José Luis Rodríguez Zapatero, the Spanish prime minister, urging him to take "resolute action" to fix Spain's economy and save the country from a bail-out by the International Monetary Fund and the EU.

Mr Zapatero, who had presided over an alarmingly high budget deficit of 11.1 per cent of GDP in 2009, did what he was told by his American and European colleagues, imposing an austerity plan that is set to reduce the deficit to around 6 per cent of GDP this year. Spain wants to stay in the euro.

The US deficit has remained stubbornly high and is forecast to be around 9 per cent of GDP this year. Mr Zapatero – whose Socialist party is expected to lose power in a general election called for November 20 – has so far wisely refrained from telling Mr Obama to fix his own fiscal crisis.

Spain has not exactly been rewarded by the financial markets for its determination, but bond market investors have at least noticed that Italy's accumulated debt is much higher than Spain's. In August – according to the interest rate spreads over Germany's benchmark Bunds – they began to regard Rome as a greater risk than Madrid.

Both countries saw their sovereign bond yields spike to dangerous levels in the first week of August, and have since benefited from a controversial bond-buying programme by the European Central Bank that initially cut yields from over 6 per cent to around 5 per cent.

That support, however, came at a price. At the insistence of the ECB, Mr Zapatero hurriedly introduced further reforms to liberalise the labour market and amended the constitution to enforce budgetary prudence by law from 2020.

The issue now is growth. Neither this government, nor the PP leaders likely to be elected in November, are sure they can continue to slash spending without tipping the country back into recession.

Victor Mallet

PORTUGAL
Exports seen as the saviour

Portugal's new government exudes resolve. The centre-right coalition is determined to go beyond the requirements of the country's €78bn bail-out agreement with the EU and IMF by overshooting fiscal targets and meeting reform deadlines early.

The aim is to gain credibility with investors and European partners as an administration that can discipline public finances and run the economy with an efficiency that will allow the country to resume financing its debt in the market by 2013.

Pedro Passos Coelho, the prime minister who took office in June, has set a target of cutting the budget deficit from 9.1 per cent of GDP last year to 0.5 per cent in 2015.

Achieving this will require the biggest public spending cuts in modern Portuguese history, reducing state expenditure by seven percentage points to 43.5 per cent of GDP within five years.

This exacting austerity programme will take a heavy toll on growth and many economists question the likelihood of a recovery as early as 2013, when the government predicts growth at 1.8 per cent, after an accumulated contraction of 4 per cent in 2011 and 2012.

Exports, predicted by the government to grow at more than 6 per cent a year to 2015, are intended to lead Portugal out of recession. But slower growth in Europe, which accounts for 74 per cent of Portuguese exports, could undermine a recovery.

Portugal's ability to cut debt at the same time as it makes the structural reforms required for a sustained export-led recovery amounts to what Mr Passo Coelho describes as the country's toughest test in 37 years of democracy.

Peter Wise

FINLAND
Eurosceptics see surge in support

Finland used to be considered one of the EU's most compliant members. These days it is emerging as a major stumbling block to eurozone rescue efforts.

Finnish public opinion has been turning progressively more eurosceptic with each fresh bail-out for Greece and other crisis-hit euro members.

This was reflected in the surge in support for a populist anti-EU party in April's general election – the True Finns won nearly a fifth of the vote, which has heaped pressure on the ruling coalition to take a tough line in Brussels.

Helsinki has demanded that Greece provide collateral in return for any further Finnish loans, but this has sparked a dispute with other euro members who want similar guarantees from Athens. The squabbling has threatened to derail the latest rescue package.

Further tension seems certain over the planned overhaul of the European financial stability facility to give the fund greater crisis-fighting powers. Jyrki Katainen, Finland's staunchly pro-EU prime minister, faces a struggle to keep his politically diverse government together on the issue.

Finland holds a crucial role as one of the six euro members whose triple-A credit ratings allow the EU bail-out fund to borrow cheaply in international markets. Finns resent their country's hard-won fiscal strength being used to prop up more profligate countries. However, with 30 per cent of Finnish exports going to the eurozone, Mr Katainen argues it is in the country's interests to help out.

Andrew Ward

ITALY
Fight for credibility continues

A founding member of the EU, Italy en tered the single currency ready to relinquish a degree of sovereignty in the hope that a competent and honest Brussels would curb the excesses of the country's own discredited political elite.

That this debt-burdened country now risks plunging the euro into a mortal crisis and thereby dismantling the wider European project comes as a shock to many Italians, who have been repeatedly assured by Silvio Berlusconi, centre-right prime minister, that Italy is safe from Greek contagion.

The billionaire entrepreneur admitted that his government's latest austerity budget was foisted on him by the ECB and drawn up in the space of four days in early August.

In the weeks that followed – while the ECB propped up Italian bonds with purchases of over €40bn – Mr Berlusconi ducked and weaved as he tried to water down the budget provisions, eroding Italy's credibility on the markets.

Two resolute pro-Europeans – Giorgio Napolitano, head of state, and Mario Draghi, governor of the Bank of Italy and the next ECB president – played critical roles in getting the government to toughen up the €54bn package that was finally passed by parliament on September 14.

The stated goal – of eliminating the budget deficit by 2013 – has failed to reassure panicky investors holding European periphery debt. Mr Berlusconi's authority over his fractious coalition to put the budget into effect is in doubt, while weakening growth prospects and rising debt financing costs undermine confidence in its projections.

Already the focus is turning to further measures the government needs to take to shore up its credibility. These include growth-promotion policies, a possibly sweeping wealth tax and perhaps a second tax amnesty. Mr Berlusconi's promise "not to put the government's hand in the pockets of Italians" is already broken.

The prime minister's personal scandals raise serious doubts over his ability to see out his full term until 2013. The stirrings of an internal party revolt are likely to gain momentum now that the crucial budget package has passed parliament.

Guy Dinmore

IRELAND
Popular backlash a possibility

Ireland's dramatic property crash saw the country follow Greece in having to seek a financial rescue from the EU and IMF. But, unlike Greece, Ireland has won plaudits for sticking to the austerity plan the donors have applied.

A popular backlash has yet to materialise despite anti-EU broadsides by all the main political parties ahead of this year's general election in February. But Ireland's EU partners recognise that the mood in Ireland has changed after Irish voters twice rejected EU treaties in recent years – only to be told to vote again. If Europe now resorts to issuing eurobonds to tackle the currency area's debt crisis, as mooted, Ireland may be required under its constitution to stage another referendum. Few believe at this stage it would pass.

Ireland's short-term political strategy is to implement the EU-IMF programme, while calling for more generous terms on the bail-out funds. It secured some relief in July and again in September when the European Commission agreed to reduce the interest rate and extend the maturities on the Irish borrowings.

But Ireland's debt sustainability depends critically on an economic recovery that is stuttering at best, with GDP forecast to rise by just 0.7 per cent this year and 2.5 per cent in 2012.

With bond redemptions and repayments on the EU-IMF funds ramping up from 2013, without a strong economic recovery it is likely Ireland will continue to be dependent on official funding.

Certainly any chance that the government will be able to return to the private debt markets to fund the budget by the end of next year, as envisaged under the EU-IMF programme, now looks a long shot. Meanwhile, the fiscal contraction that still has to take place is considerable.

John Murray Brown

NETHERLANDS
Economic shifts bring anxiety

One of the most open and trade-dependent economies in Europe – trade comes to 150 per cent of GDP, against a eurozone average of 80 per cent – the Netherlands was an early backer of European monetary union and has done well by the euro. Real GDP per capita is up 10 per cent since 2000, against a eurozone average of 6 per cent. Unemployment has been low for a decade, and was scarcely touched by the financial crisis; at 4.3 per cent, it is the second-lowest in Europe after Austria.

But with their Calvinist culture, triple-A credit rating and low budget deficits, the Dutch were always uneasy at the prospect of monetary union with free-spending governments in southern Europe. The powerful far-right politician Geert Wilders calls the country's support for Greece "throwing money over the dikes". Polls in August found most Dutch wish the country had never joined the euro.

The anxiety reflects deep economic shifts. Being an open economy has its costs, and many companies that long defined the Netherlands' brand have gone foreign. Shell, Unilever and Reed Elsevier are Anglo-Dutch condominiums. KLM has merged with Air France. ABN Amro's international banking ambitions collapsed after its failed merger with RBS and Fortis.

The Netherlands' economy rises or falls with its European trading partners. Whether the Dutch are willing to kick in more money to keep those partners afloat is another question.

Matt Steinglass

GREECE
Pace of reform raises concerns

Greece's debt crisis has plunged the country into its worst recession in 60 years, while the lagging pace of fiscal and structural reform is raising doubts about whether the government will be able to avoid an eventual default. Opinion polls show an overwhelming majority of Greeks are opposed to leaving the eurozone.

Yet Greece is struggling to achieve this year's budget deficit target under the terms of its current bail-out by the EU and IMF.

Recent announcements of a new property tax aimed at raising €2bn by December, along with moves to sack more than 20,000 workers within weeks, mark a last-ditch attempt by Athens to put fiscal consolidation back on track.

This may be enough to secure the disbursement of the next €8bn loan tranche. But Nicolas Sarkozy and Angela Merkel, along with senior Commission officials, have warned George Papandreou, prime minister, that he must accelerate the pace of reform to ensure the second rescue package goes ahead as planned.

One worry is that an ambitious €28bn privatisation programme included in the new package is behind schedule. Another is that Greek banks are in urgent need of recapitalisation after taking haircuts of around 20 per cent on their bond portfolios as a condition of the second bail-out.

Yet Greek lenders are showing reluctance to seek funding from an IMF-backed bank stability facility because the state would become their majority shareholder.

But with the economy projected to shrink this year by 5.3 per cent and another 2 per cent in 2012, and unemployment already at 16 per cent, policymakers in Athens cannot afford further delays in implementing reforms.

Kerin Hope

Faded star: the future of Europe's monetary union remains unclear AP

Fiscal fix: Barack Obama's jobs plan will make US compliance with the Toronto deal on deficits difficult Bloomberg

Austerity drive slides into rancour and risk

Public finances

German and US moves keep fiscal policy in flux, writes **Chris Giles**

At the Toronto summit in June 2010, leaders of the Group of 20 leading nations thought they had settled the vexed issue of the degree and pace of budgetary consolidation after the economic crisis.

Everyone signed up to the proposal that advanced economies (except Japan) would halve their budget deficits by 2013.

The pledge was designed to inspire confidence that governments had a grip on public finances and would lower borrowing as recovery continued. It was the moment the advanced world moved from stimulus to austerity and the proposals had widespread support.

No longer.

A year later, fiscal policy is again in flux. The US scraped a political deal to increase its debt ceiling before the world's largest economy descended into likely default in August. Standard & Poor's, the credit rating agency, alarmed by the political damage caused by the debt ceiling fight, downgraded the US triple-A rating, sending markets into a tailspin.

Internationally, the disputes over fiscal policy, which characterised the supposedly harmonised response to the 2008-09 financial and economic crisis, restarted as the global recovery stalled.

Germany is under pressure to loosen its fiscal ties against its will. Christine Lagarde, the new managing director of the International Monetary Fund, has urged countries with the means to slow their austerity drives. The Organisation for Economic Co-operation and Development trod the same path in its September recommendations.

But Germany is putting strong pressure on the rest of the eurozone to cut deficits quickly, as storm clouds gather over Italy, Spain and Greece. It is dismayed that Barack Obama, US president, announced a jobs plan, cutting taxes and increasing spending at a rate that would make US compliance with the Toronto agreement difficult.

What once appeared a straightforward process of delivering what many thought was a reasonable budget deficit reduction plan amid a gradual recovery has suddenly become fraught with rancour and risk.

> Germany is putting huge pressure on the rest of the eurozone to cut deficits quickly

By the time the Group of Seven finance ministers and central bank governors met in Marseilles this month, there was ill-disguised frustration with the fiscal plans of other countries.

But the truth behind all these disputes is much more complex than the headline tensions suggest. Hidden behind claim and counter-claim are surprising starting points from which each country was adjusting policy this autumn.

Contrary to received wisdom, the US did not have the loosest fiscal plans of advanced economies. In fact, with tax cuts due to expire at the end of 2011, before the president's speech, the administration was planning the deepest austerity drive in 2012 of any G7 country. It was seeking to close its underlying deficit by 1.4 percentage points of national income in 2012.

If Mr Obama can get his proposals through Congress – a big if – the US would only slightly relax its budget deficit by 0.4 percentage points of national income in 2012, according to Goldman Sachs, a move that hardly counts as a large fiscal stimulus.

In contrast, while Germany preaches austerity to the rest of Europe, it has the loosest plans for fiscal consolidation in the G7 for 2012. According to the IMF, its underlying deficit was set to fall only 0.6 percentage points, albeit from a low level to one even smaller.

The challenge now is to set fiscal policy at a time of deep uncertainty over two vital variables.

First, it remains unclear whether private-sector demand is so weak that government is the only economic actor willing to spend.

Second, people can only guess the effects of fiscal consolidation at a time when every leading economy is trying to get borrowing down simultaneously.

Global fiscal policy remains unresolved and the G7 was reduced to empty statements in Marseilles. When ministers call for "growth-friendly fiscal consolidation", as they did in Marseilles, their objective is evident, but their policies and likely reaction to shocks are undefined.

With the big issues in flux, countries are enshrining their existing deficit reduction programmes in legislation in an attempt to convince markets that their resolve is strong.

If the world economy continues to slide, fiscal policy will not be set by legislation but by the altogether more unpredictable whims of the wider global recovery.

Banks locked in vicious circle as regulators debate tougher rules

Reforms

A debate is raging about how much lenders should do to protect themselves, writes **Patrick Jenkins**

After faint hopes last year of a sustained global economic recovery, it is clear that a second leg of the financial crisis, three years after the first one peaked, is dispelling hopes of anything better than stagnation for the years ahead.

At the centre of that dynamic are the world's banks – the cause of the woes of 2007 and 2008 and now, in large part, victims of a "feedback loop", as the cost to governments of funding state bail-outs compounds underlying economic woes. With so much of that now shaky-looking government debt in the hands of banks, particularly in the eurozone, a vicious circle has developed that is proving all but impossible to break.

The surprise is that after more than 12 months of fairly sustained pressure on the weakest parts of the eurozone periphery, more banks have not collapsed. Aside from a part-nationalisation of the Irish banking system, most banks have survived.

Regulators – midway through implementation of reforms drafted in the wake of the 2008 crisis – are adamant that without the drive to toughen capital and liquidity requirements there would have been more victims.

But a row is raging about how much further banks need to go to protect themselves from the latest woes. Is this the time to beef up buffers? Or, in the midst of a crisis, should regulators be letting banks eat into reserves – the so-called counter-cyclical strategy. The markets are clearly torn. Credit Suisse, for example, had outperformed rivals on the stock market thanks to strong capital buffers, but has slumped recently, as fears mount that generating sufficient returns on those higher equity levels will be tough.

Yet, at the same time, France's banks became the butt of the sell-off of eurozone banks, because of a combination of relatively high exposure to the Greek economy, compounded by slimmer capital buffers than most European rivals.

Christine Lagarde, the new managing director of the International Monetary Fund, made waves when she said there should be "urgent" recapitalisation of European banks, to allow them to take the proper writedowns on the value of troubled eurozone debt, in preparation for possible defaults.

Jamie Dimon, head of JPMorgan, described the new Basel III global rulebook on capital and liquidity as 'anti-American'

Within a fortnight, Jamie Dimon, chief executive of JPMorgan, had added his polar-extreme view, describing as "anti-American" the new Basel III global rule book on capital and liquidity. The US should consider pulling out of the agreement, he said.

Yet it seems certain that banks everywhere will have to hold higher levels of capital and liquidity – slashing profitability from the pre-crisis norm of 20-30 per cent return on equity to more like half that, at best.

But regulators should go further, says Andrea Enria, head of the European Banking Authority, the oversight regulator for the European Union. "[Extra capital] is extremely important," he told a recent Financial Times breakfast debate on the Future of Banking. "But it's important that we strengthen supervision. I think we have a major task ahead in dealing with [systemic risk]."

The concerns apply as much to the so-called "shadow banking" environment of hedge funds and money market funds as to banks themselves, as tougher rules for lenders push business into less regulated institutions.

Some countries are going further than the baseline global norms set by the Basel Committee of regulators. On September 12, the UK's government-appointed Vickers Commission recommended sweeping changes to the structure of the country's banks. In a report backed by the government, with legislation promised by 2015 and implementation by 2019, so-called universal banks operating in Britain – with retail and investment operations under one roof – will have to separate those businesses with a "ringfence".

The idea is that barring the use of high-street deposits to back investment banking will make the businesses safer. At the same time, it will remove in the UK the kind of implicit government guarantee that has existed in many countries since institutions from Northern Rock to Commerzbank were bailed out three to four years ago.

Most bankers and regulators believe the structure will remain a British preserve, with other countries adopting their own reforms.

More regulation is coming, though, with the Basel Committee yet to rule on the exact liquidity requirements that banks should hold for the short term, and also on the maximum mismatch that should be allowable between short funding terms and long lending commitments. Everyone has their fingers crossed that Europe's banks can make it through the current malaise without those additional safety measures in place.

Finance ministers stare into abyss

Continued from Page 1

Brazil in particular, feel the time has come when they should worry less about inflation and cut interest rates to underpin expansion. Others, including China, are playing a waiting game. And India is so concerned about inflation that its central bank raised interest rates in September.

Two things are creating the turbulence in the global economy. First is the eurozone, which is struggling with a conflict between its relatively healthy economic fundamentals if it were a unified country and the fact that it is a combination of 17 economies with often divergent interests.

Given that the eurozone's aggregate fiscal position is better than all other large advanced economies – the US, Japan and the UK – the euro crisis could be solved with greater pooling of tax receipts and policy.

Replacing national sovereign debts with eurobonds would solve the immediate crisis. But the more solvent north – Germany, the Netherlands and Finland – would have to accept to a degree the liabilities of the south – Greece, Ireland, Portugal, Spain and Italy.

That would be an enormous political step, as would the periphery's resultant loss of sovereign policy-making.

Without a shift in this direction, the euro might not be able to survive, especially if the public begin to believe a split is possible.

As professor Larry Summers of Harvard University and former chief economic adviser to Barack Obama, said this week: "Now, when these problems have the potential to disrupt growth around the world, all nations have an obligation to insist that Europe find a viable way forward."

The eurozone woes are replicated at a global level. Huge trade surpluses in oil producers, in China, Germany and Japan are financing deficits, predominantly in the US. With US politicians unable to agree on a stimulus to keep these trade patterns going, the alternative is that the global economy rebalances at a lower level of output, the depression everyone has worked so hard to avoid.

The stakes could not be higher as the G20 meets in Washington. A solution to the numerous contradictions in the world economy is not needed immediately.

But time is running out.

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World Economy | Central Banking

The third arm Macroprudential policy

There is little left in officials' monetary and fiscal armoury. But fear not. Andy Haldane, the executive director for financial markets at the Bank of England, says the only thing we have to fear is fear itself.

Why? "With fortuitous timing, there is a new tool in the box, a third arm of macroeconomic policy," Mr Haldane said in August. The third arm is, of course, macroprudential policy.

Macroprudential policy is not in fact new. The phrase has been around since the late 1970s, when it was coined by the Cooke Committee, the forerunner of the Basel Committee on Banking Supervision. It has been used, with varying degrees of success, by policymakers in Asia – and Spain – for many years.

But only since the crisis exposed the deficiencies of relying on existing policies, and market discipline, to curb the excesses of credit and liquidity cycles, has it become a buzzword.

The policy counters dangers to the financial network as a whole. It does so by regulating the availability of credit and managing liquidity.

In contrast to monetary policy, which for the most part relies on interest rates as the sole policy tool, a number of instruments count as macroprudential.

Tools can be split in two types: the countercyclical, which counter the peaks and troughs of credit cycles, and the structural, which limit the fallout of a firm's failure.

Policymakers agree that countercyclical buffers, loan-to-value ratios and liquidity coverage ratios should be in the toolkit. But they are split on what else should count as macroprudential.

Brazil – to the chagrin of policymakers elsewhere – has said its decision to impose capital controls in the form of a tax on foreign investments was made on macroprudential grounds. Such divergence is likely to become part and parcel of the policy strand.

Various measures can help to promote financial stability, but only some are clearly macroprudential. Countries' priorities differ on what the most important sources of financial stress are, so macroprudential policy will differ from jurisdiction to jurisdiction.

Asian policymakers' use of macroprudential tools has focused on loan-to-value ratios, which limit the amount a mortgage holder can borrow against the value of the property.

Research by Natalia Lechmanova at Standard Chartered Bank suggests that the use of such ratios by several Asian economies – including Hong Kong, Singapore, Korea and China – has been more effective when coupled with monetary policy. "Monetary policy alone is not sufficient to prick asset-price bubbles, neither is macroprudential regulation. They complement rather than substitute for one another," she says.

The research points out that in Hong Kong and Singapore, despite tightening of macroprudential measures, property prices continue to rise. But in South Korea – where macroprudential measures have been coupled with tight monetary policy – house prices have stabilised.

"Rising property prices may indicate macroprudential measures can only do so much if monetary policy is incorrect," she says. That Spain's implementation of a countercyclical capital buffer – counteracted by low interest rates in the eurozone – failed to stave off recession would also point to this.

With interest rates likely to remain the predominant policy tool, the findings are significant to policymakers elsewhere. However, the lessons that can be drawn from Asia's experience are limited by differences in the political climate. The Bank of Israel's attempts to use macroprudential measures to damp the country's housing bubble have met with anger in the media, with claims that the measures favour foreign investors over first-time buyers. This is likely to result in policymakers in the west opting for measures which less obviously favour any segment of society.

Another problem is a lack of evidence for policymakers to draw on in setting macroprudential policy.

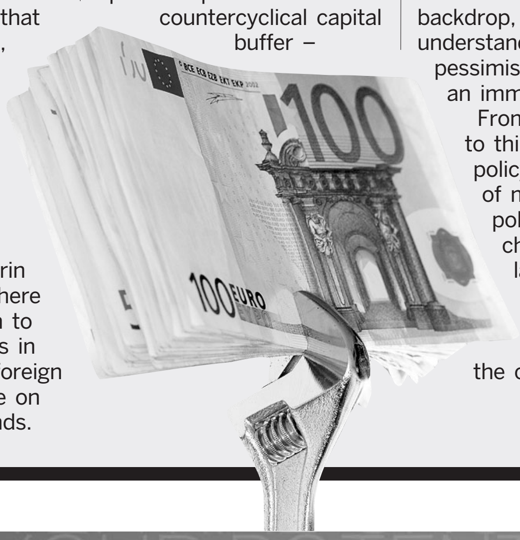
Richard Barwell, a Royal Bank of Scotland economist, said in a research note: "In contrast to the situation where the Bank was given independence for monetary policy in 1997, very little is known about how to do macroprudential policy. The Financial Policy Committee will not . . . be able to draw on decades of research."

Implementing macroprudential policy, will be a case of trial and error, as officials are well aware.

Mr Haldane said in an interview with Central Banking Journal last year: "The authorities will be sailing in largely uncharted waters in a new boat with a new crew. Against that backdrop, it is perhaps understandable that some pessimists have predicted an imminent shipwreck."

From invisible hands to third arms, policymakers' espousal of macroprudential policy is characteristic of a lack of faith in markets. The policy, though, may not prove the complete answer.

Claire Jones



Lost in the hills: central bankers are undecided on whether to press ahead or run for cover — Alamy Images

The path to recovery proves to be a long and painful one

Central banks

There is still no consensus on the risks of extra monetary stimulus, says **Robin Harding**

Three years after the peak of the Great Recession, the world's central bankers are like a walking party that has set off for a very long trip in the mountains and remains far from its destination.

Despite trillions of dollars of quantitative easing, huge liquidity operations and a range of experiments in central bank communication, the legacy of the financial crisis has not yet been overcome.

In the US, households are still burdened by high levels of debt held against homes that continue to fall in value. In Europe, meanwhile, government debt burdens have led to a particularly corrosive financial malaise. Both are holding back growth.

There is some fatigue and grumpiness among the central banking group and plenty of dissent about what to do next.

One group – well represented by a European Central Bank that has raised interest rates in two steps this year from 1 to 1.5 per cent – wants to get down off the mountains and take shelter.

It thinks that slogging on with extra monetary stimulus involves large risks in return for little benefit.

Another group – including academic economists such as Paul Krugman along with central bankers such as Adam Posen at the Bank of England and Charles Evans of the Chicago Fed – thinks that the real danger is that the party has not been moving fast enough.

They argue, in essence, that central banks should cast aside some of their baggage, take a little more risk and strike out hard for the destination of full employment.

"Both the UK and the global economy are facing a familiar foe at present: policy defeatism," said Mr Posen in a recent speech.

His solution is more quantitative easing, which means buying assets in an effort to drive down long-term interest rates, and an effort to transmit that effect via a state-backed bank to channel credit to small businesses.

Mr Evans, by contrast, has become the first US central banker to countenance the idea that temporarily higher inflation could be an effective way to ease policy. If people expect higher inflation, they have a stronger incentive to spend or invest their money now, he says.

The latest formulation of Mr Evans' ideas is an elegant "trigger" strategy that puts his goal in a way that is easy to communicate. He suggests the Fed pledges to hold interest rates exceptionally low until unemployment has fallen from its current level of 9.1 to 7.5 per cent, "as long as medium-term inflation stays below 3 per cent".

For now, however, most of the central bankers on this long walk are inclined to press doggedly onwards.

They will not countenance the risks of aggressive action, nor will they lay down their burden of trying to ensure low but stable rates of inflation.

The Bank of Japan, which has been dealing with stagnant prices for longer than any other central bank, has slowly ratcheted up its asset purchases and its attempts to push down longer-term interest rates.

The Federal Reserve, while setting a very high bar for a "QE3" round of asset purchases, has returned to efforts at easing policy.

In August, it said that conditions were "likely to warrant" keeping interest rates close to zero "at least through mid-2013".

The general idea behind these moves is that the benefits of further monetary policy easing are limited; the risks – mainly in terms of the credibility of the central bank's promise not to finance government spending – increase the further the easing goes.

> 'Monetary policy can do enormous harm by trying to withdraw liquidity'

"Monetary policy can do an enormous amount of harm by trying to withdraw liquidity at a time when banks, firms and households have a very strong desire to be as liquid as they can possibly be," says Neal Soss, chief economist of Credit Suisse in New York.

The benefits of further easing, however, are much smaller. "It is an extremely asymmetric challenge," he says.

As Neil Williams, chief economist at Hermes Fund Managers in London, puts it: "If consumers still can't repair their balance sheet when the true monetary policy rate [adjusted for quantitative easing] is minus 3 per cent" it is hard to be too optimistic about the outlook or the effects of further easing.

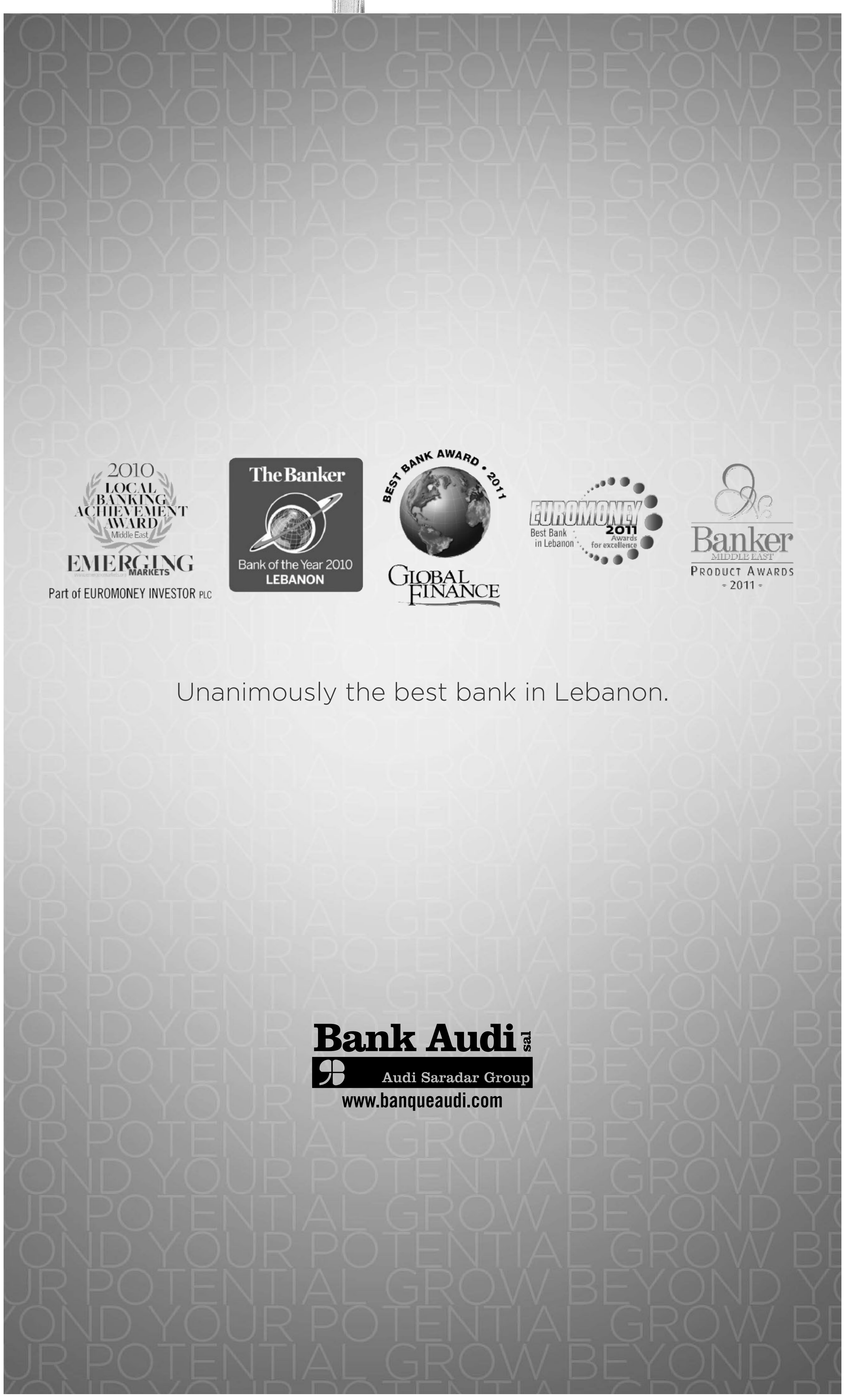
Taking a step back from their immediate policy concerns, the broad question that central banks have to answer is whether it is more damaging to suffer a long period of high unemployment that would mark a failure of the whole economic policy apparatus, or whether to take risks that could lead to failure on their own specific responsibilities of inflation and financial stability.

For Mr Soss, it is the financial sector that will be in greater peril if monetary policy remains very easy for a long time. Inflation, he says, is unlikely, so long as consumers prefer cash in their pockets to consumption.

As long-term interest rates are driven ever lower, banks, insurers and pension funds are left with only "low-calorie" assets that yield a couple of per cent a year," says Mr Soss.

"Yet the liabilities they have left over from the past are pretty high-calorie," he adds, so an eventual rise in interest rates would be painful.

For the central banks, there is still a lot of ground to cover before they can take their hot bath and cold beer at the end of their journey back from the Great Recession.



Optimistic investors in short supply as volatility continues

Markets

The euro crisis and US recession are hitting confidence, says **Norma Cohen**

If investors' expectations of tomorrow are what drive markets today, many of the world's developed economies face a rough ride in the months ahead.

At the start of 2011, stock and bond markets were near their high point of recovery since the darkest days of the recession in the first quarter of 2009, and for much of the first half of this year prices mostly moved sideways.

But from about June – and coinciding with a rising drumbeat of weaker-than-expected economic readings from many developed markets and the revelation that the US recession had been deeper than thought – stability evaporated.

Moreover, equity and debt strategists say, there is no end in sight to the current turmoil. "This time it's different," says Graham Secker, equities strategist at Morgan Stanley.

Since the start of the year, the S&P 500 index is down 4.3 per cent, the FTSE 100 off by 10.9 per cent, the Eurofirst 300 has fallen 18.3 per cent and the Nikkei is down 14.7 per cent.

In particular, there are deepening concerns about the stability of European banks, whose holdings of sovereign debt issued by the most fiscally fragile of eurozone governments – Greece, Portugal, Ireland and possibly even Spain and Italy – look frighteningly large, given their relatively thin capital cushions. Those fears have fed on themselves, as lenders to the banks – US money market funds in particular – withdraw their short-term loans.

Mr Secker says: "There has been a structural deterioration in the outlook for stocks, given the relapse in growth and further escalation in the eurozone debt crisis. We believe developed market economies are now at the end of their debt supercycle."

Only concerted action by central banks to shore up fragile economies is likely to reverse the trend. Even Germany, the powerhouse of Europe, saw its gross domestic product grow only 0.1 per cent between the first and second quarters of 2011.

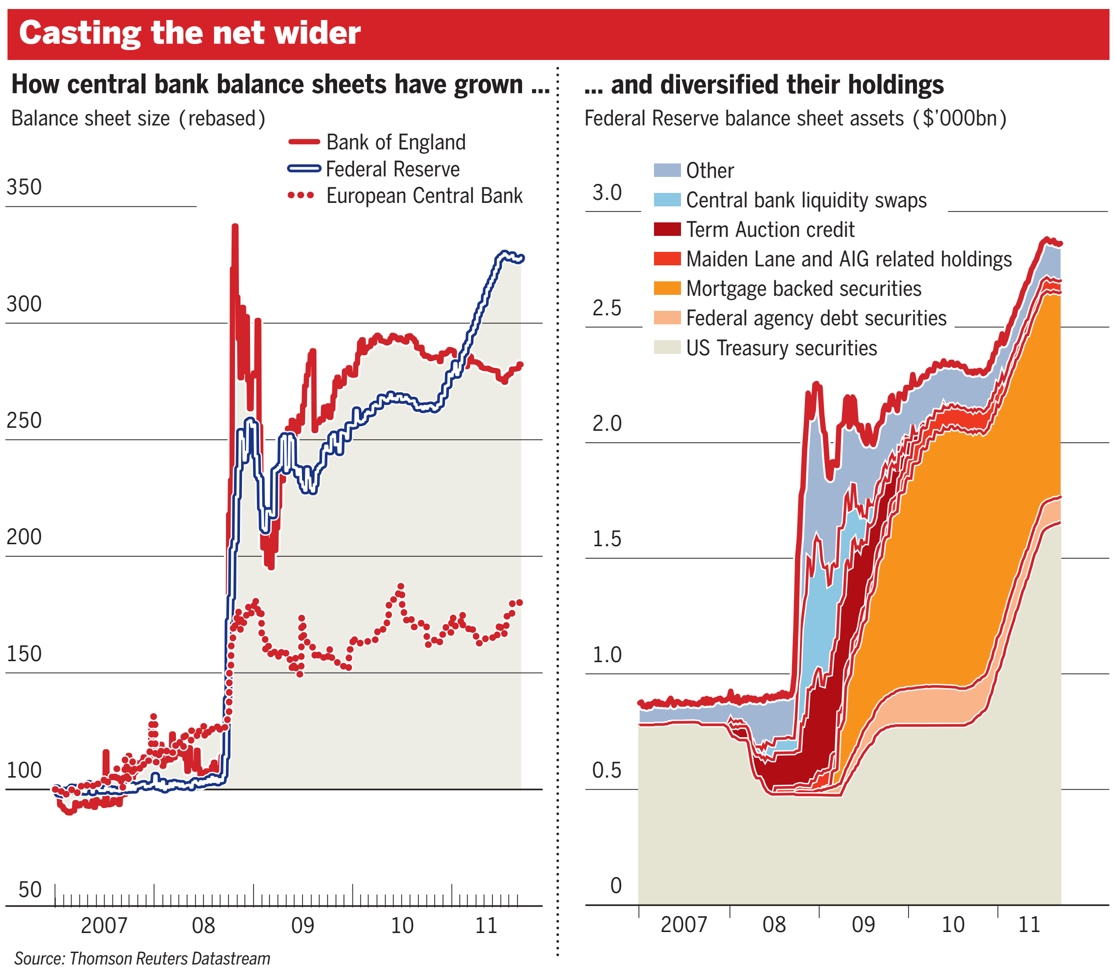
Equity investors, Mr Secker says, are likely to remain sellers of stocks until three things happen: first, large-scale purchases of securities from the European Central Bank (quantitative easing); second, new fiscal strategies from developed economies aimed at providing short-term stimulus while laying out concrete plans to cut long-term expenditure; and, third, the writing down of debts to levels that reflect the likelihood that partial defaults may occur.

Not everyone is as pessimistic. Nick Nelson, equities strategist at UBS, notes that markets are not necessarily accurate predictors of economic trends: "Our central

Central banks walk a monetary tightrope

Balance sheets

Claire Jones looks at the risks and rewards of recent measures to supply liquidity



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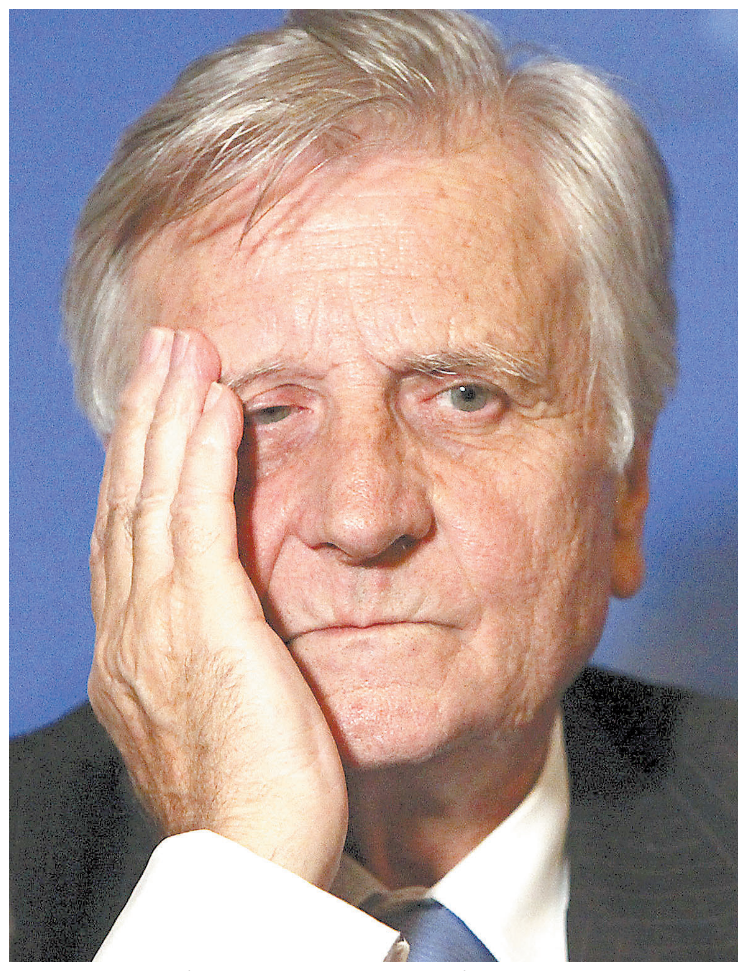

Under fire: Jean-Claude Trichet defended ECB balance sheet Bloomberg

It is a fundamental tenet of central banking, enshrined in Walter Bagehot's fabled *Lombard Street*, that in times of crisis the world's monetary guardians lend abundantly against good collateral for an onerous fee.

Central banks have indeed provided ample liquidity to markets, playing a vital role in staving off a financial meltdown. More contentiously, they have accepted collateral that even their most ardent defenders would struggle to label "good". They have also bought government bonds and other securities from investors under quantitative easing.

All of which is reflected in the expansion of advanced-economy central banks' balance sheets.

Only after Lehman Brothers failed did balance sheets expand sharply, as funding pressures intensified – though in the early stages of the crisis the composition of assets shifted as the central banks' broadened their range of eligible collateral to account for funding strains in the markets for all but the safest instruments.

Since October 2008, the Federal Reserve has purchased $2,150bn of assets, of which $1,250bn were mortgage-backed securities, and $900bn treasuries. The Bank of England has bought £200bn of assets, the bulk of them gilts. More quantitative easing may soon follow on both sides of the Atlantic. The European Central Bank had bought, as of September 12, €143bn ($197bn) in Irish, Greek, Portuguese, Spanish and Italian government debt.

Most of these measures are not without their critics, who contend that such actions hamper monetary authorities' independence. Jean-Claude Trichet, the ECB's president, this month felt moved to defend the central bank by saying its balance sheet had expanded by only 77 per cent since the crisis, against 226 per cent for the Federal Reserve and 200 per cent for the Bank of England.

Two dangers are that the expansion could stoke inflation or result in losses that could erode central banks' slim capital buffers. Both could have implications for their independence.

Inflation expectations, for now, remain well anchored. And one need only look at Japan to see that an increase in the amount of cash swilling round an economy does not necessarily result in price pressures, especially after a banking crisis.

Hitting back at oft-heard barbs that the Bank of Japan did too little to combat its banking crisis, Masaaki Shirakawa – its current governor – has said that the ratio of the central bank's balance sheet rose to some 30 per cent of GDP in 2005. Speaking last September, he said: "That is twice as large as that by Federal Reserve, the ECB, and the Bank of England in the recent crisis."

Six years on, Japan remains locked in if not deflation, then inflation so low it offers little incentive to spend now.

Central banks' willingness to take on riskier assets could net a tidy profit. The Fed declared a record payment to the Treasury for 2010 of $80.9bn, most of it from interest earned on the riskier assets it now holds. That could easily be reversed, producing big losses which could erode central banks' capital buffers.

Owing to their ability to profit from note-printing and their traditional aversion for risky assets, central banks' capital buffers are understandably minute. The Fed's buffer is $26bn against a balance sheet of $2,800bn – less than 1 per cent. Even after an increase of €5bn last December, at €10.76bn, the ECB's is an even smaller proportion – just half a per cent of its €2,070bn balance sheet. The Bank of England's is 2 per cent – £4.4bn against its balance sheet of £225bn. It has also increased its capital buffer from £1.86bn in 2007.

The Bank has, however, ensured that its quantitative easing programme and its special liquidity scheme are structured in a way that the UK Treasury would pick up the tab.

The Fed also has a similar arrangement for the first chunk of losses on some of its crisis-fighting facilities and changed its accounting rules this year so it could defer its weekly payments to the US Treasury were it to incur losses.

Central bank losses are never ideal. But it is preferable for the loss to be the result of action that has an explicit government indemnity.

There is no such indemnity for the ECB's securities markets programme. In the event that the ECB were to make a loss so great that it eroded its capital buffer, it would first go to the national central banks of all European Union members.

If they lacked adequate resources, the national central banks would have to ask their governments for support.

That central banks have inflated balance sheets and hold riskier assets is far from ideal. Yet Mr Shirakawa is still having to defend the Bank of Japan against claims they did not do enough. It is a difficult tightrope that the world's monetary guardians tread.

Mario Draghi Set to inherit an ECB in crisis

The challenges facing Mario Draghi, when he takes over as European Central Bank president on November 1, could hardly be greater, **writes Ralph Atkins**.

In the midst of the biggest crisis since the euro's launch in 1999, the Italian central banker has to shore up investor confidence in the region's stability, avert financial meltdown and steer its economy back towards sustainable growth. He will also be aware of the ECB's stated main objective: controlling inflation.

But the terrain is not unfamiliar to Mr Draghi, an experienced crisis manager. In the early 1990s, he headed Italy's treasury at a time when the public-sector deficit had soared to more than 10 per cent of economic output, inflation was nearly in double digits and homegrown terrorism was still a threat. "It was a situation that was certainly worse than one could ever imagine today," he recalled in an interview with the Financial Times last year. Mr Draghi helped implement a strict fiscal austerity plan and catastrophe was averted.

After that formative experience, Mr Draghi worked at Goldman Sachs, the US investment bank, which appointed him vice-chairman and managing director in 2002. Three years later, he took over as governor of the Bank of Italy, replacing the disgraced Antonio Fazio.

Born in 1947 into a middle-class family in Rome, Mr Draghi was orphaned as a teenager and for a while was brought up by an aunt. His rigorous education at Rome's Jesuit school instilled a cautious approach to the world. He also had extensive training as an economist. Under Franco Modigliani, a Nobel economics laureate, he became the first Italian to gain a doctorate at the Massachusetts Institute of Technology.

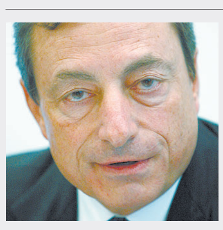
Mr Draghi then taught economics and finance at Italian universities and was a World Bank director for six years.

Mr Draghi is disciplined and sometimes enigmatic – useful attributes in a central banker. Recently, he has kept a low profile, taking care not to undermine the authority of Jean-Claude Trichet, incumbent ECB president, with any hints of dissent.

Those familiar with his thinking report that his career has taught him the virtues of pragmatism. Thus he has supported the ECB's adoption of extraordinary measures to tackle the eurozone debt crisis, including its controversial bond-buying.

Nevertheless, Mr Draghi has cultivated the image of a monetary policy "hawk" or hardliner – which explains why he was able to win support, eventually, for his nomination as ECB president from Angela Merkel, the German chancellor. The way for his selection became clear in February, when Axel Weber, Germany's Bundesbank president, withdrew from the contest citing differences with other eurozone governments on ECB strategy.

Germans fear that Mr Draghi will be soft on fiscally imprudent southern European countries. The fear in Italy, however, is that an early desire to win German support for


Draghi's image as a monetary policy hardliner helped win German chancellor Angela Merkel's support for his nomination as ECB president

the ECB will increase further the pressure on Rome. He has joined with Mr Trichet in piling pressure on Silvio Berlusconi, Italy's prime minister, to implement fiscal and structural reforms. "If you look at his record on the Italian government, he is one of the central bankers who has taken the toughest stance," says Elga Bartsch, European economist at Morgan Stanley.

In practice, Mr Draghi will only be able to act with the backing of the ECB's 23-strong governing council, comprising central bank governors of the 17 eurozone countries and six Frankfurt-based executives. That will require him to become expert at consensus building. Less passionate in public than Mr Trichet, he is nevertheless also likely to be active behind the scenes in lobbying governments into taking action – to avert immediate crises and secure the eurozone's longer-term stability.

economic view is that we will avoid the recession next year, but that markets are getting ahead of themselves." While there are multiple challenges – the sovereign credit crisis in Europe, political paralysis in the US – he still expects some modest growth.

More worrying, he says, is that markets appear to be pricing in a bigger slowdown in corporate profit growth. The surge to record nominal prices for gold and in the Swiss franc indicate wider panic about the stability of the system.

Indeed, the unusual volatility in world stock markets comes as companies appear to have weathered the recession better than many could have imagined. "Company cost-cutting in 2009 was very successful," Mr Nelson says. The average net debt/equity ratio of developed markets is now 40 per cent, about as low as it has been at any time in the past 12 years. Profit margins on earnings before interest and tax, with the exception of the financial

Flight to safety: panic buying of gold and Swiss francs

sector, are about 13 per cent, a 30-year high.

If anything, companies are hoarding cash as never before, a trend Mr Nelson says is a function of the "emotional scarring" managements received in 2008. Nevertheless, investors are pessimistic.

Bond markets, it seems, are little better. Gary Jenkins, head of credit strategy at Evolution Securities, says certain indices that are bellwethers of risk were remarkably stable until the start of summer. "Corporates have been a haven," he says.

Until late May, the iTraxx Crossover Index of credit default swaps on lower-rated corporate bonds was stable.

But in recent weeks, that has changed. For example, a subcomponent of the index that tracks the subordinated debt securities of financial institutions is pricing credit default swaps for the sector at 560 basis points ($560,000 to insure $10m of bonds against default). In 2008, following the collapse of Lehman Brothers, the sector cost 300bp to insure. "The bond market is sending very worrying signals," he says.

On the other side of the coin are debts of stronger sovereigns such as the US and Germany. In the former, yields on 10-year Treasuries have fallen below 2 per cent – a record low – while yields on bunds of a similar maturity are not much higher. "Either people are very scared and seeking a haven or are expecting deflation," Mr Jenkins says.

Uphill battle for French G20 presidency

Global growth

The leading economies need to find common ground, says **Chris Giles**

Talking heads: leaders of G20 countries will again have discussions on strong, stable and balanced growth, even if they find it difficult to agree on specifics AFP/Getty

Grand ambitions were the order of the day when France took over the presidency of the Group of 20 leading economies and the Group of Eight in January.

Gone was South Korea's low-key chairmanship of the world's "premier forum for international economic co-operation", to be replaced by showmanship from Paris.

Nicolas Sarkozy, French president, launched his 2011 G20 mission with the vision of creating a new international monetary system. "We live in a new world, so we need new ideas," he said. The proposal sought to tame volatility in currency and commodity markets, damp global capital flows and solve global trade imbalances which he said were caused by "international monetary disorder".

Some of the plan was more evolutionary than revolutionary and Mr Sarkozy insisted he did not want to usurp the status of the dollar. Yet he showed his desire for change by saying the dollar could not act as the world's sole reserve currency. "The emergence of new economic powers will lead to the emergence of new international currencies," he said.

While the grandiose language was never to the taste of most G20 countries, the first step on the journey to a new international monetary system was the implementation of previous G20 agreements to create a "strong, stable and balanced" global economy.

In mid-February, G20 finance ministers gathered in Paris for what turned out to be a harbinger of the challenges that have beset the French G20 presidency ever since. The meeting was supposed to be routine, with finance ministers agreeing a set of indicators that might be used to assess whether their economies and policies fostered balanced global economic growth.

Far from France undermining the meeting with excessive ambitions, countries struggled to agree even the most basic steps to a more stable world economy.

A country's current account surplus or deficit is the accepted measure of balance in its relations with other countries, but the Chinese arrived in Paris in intransigent mood. Their negotiators refused to let the G20 use the current account as an indicator of balance. After an all-night session, the absurd compromise China accepted was that countries were allowed to assess every component part of a country's current account, but the term "current account" was banned.

That ended the French presidency's lofty plans. From then on, limited goals became the order of the day, a shift that has been reinforced as the year has progressed.

The slide into stagnation, the eurozone sovereign debt crisis, the US debt ceiling crisis and the re-emergence of currency wars with the Swiss decision to cap the value of its franc have ensured that efforts to revive growth in the world economy will form the centrepiece of the French presidency for the rest of the year.

"We are now back in the world of immediate issues, not how to redesign the monetary system for the next 50 years," says one G20 official close to the discussions.

An exhausting round of meetings started in mid-September when the finance ministers and central bank governors of the Group of Seven leading advanced economies gathered in Marseilles. Markets were swooning and, as the meeting started, news came in that Jürgen Stark, the hawkish German board member of the European Central Bank, had resigned in disgust at the ECB's purchases of huge amounts of Spanish and Italian government debt.

The G7 meeting did not augur well for the G20 summit in Cannes in November. The G7 failed to come up with a co-ordinated plan; agreed to disagree on many important matters; and resolved that every country should do what was right for it.

Of the original French ambitions, little is left. But presidencies of the G20 are never allowed to come away from a year of hard graft with nothing. There are still areas on which hopes are high of agreement at the Cannes summit.

Some specific and limited global regulations are likely in commodity markets. There is still effort in securing agreement on the controls countries are allowed to impose on capital flows. Efforts are also continuing in finding new lending facilities for the International Monetary Fund. And countries will again have to face up to discussions over strong, stable and balanced growth, even if they find it difficult to agree anything specific.

One carrot being offered to China is the inclusion of its currency, the renminbi, in the calculation of the IMF's supranational money, the special drawing right. If the regime accepts and China offers concessions on its currency and domestic spending to earn the prize, Mr Sarkozy's G20 presidency will be judged a success.

Lagarde faces tough baptism over Greek debt

IMF

The new head is set for a showdown with Europe, writes **Alan Beattie**

On July 5, Christine Lagarde became the 11th successive European and fifth French head of the International Monetary Fund since the organisation started operations in 1946.

Ms Lagarde, French finance minister before her appointment, took over from her compatriot Dominique Strauss-Kahn, who is generally remembered at the IMF for his work in restoring its relevance to international crisis management, rather than the manner of his leaving the fund.

After a decade in which a booming global economy and confident investors diminished the demand for emergency rescue lending for crisis-hit countries, the fund looked like an organisation in search of a mission.

It attempted to insert itself into – or gave way to US pressure to enter – debates about misaligned exchange rates and rebalancing the global economy, which produced little but the usual stalemate between Washington and Beijing over the renminbi.

Christine Lagarde has distanced herself from European policymakers

Mr Strauss-Kahn seized the chance presented by the global financial crisis, particularly when it entered its sovereign debt phase in late 2008.

First in a string of central and eastern European countries and then in Greece, Ireland and Portugal, Mr Strauss-Kahn overcame reluctance from the European Central Bank and others to have the IMF involved.

But with its involvement came risks to its finances and its reputation, which Ms Lagarde has now inherited. Unusually, the fund has provided a minor share of the money for the Greek, Irish and Portuguese rescues, with most coming from two other parts of the "troika" – the European Commission and the ECB.

The first Greek rescue programme, launched in May 2010, was criticised by many economists for over-optimism on growth and failing to include a write-down of Greece's huge sovereign debt owed to the private sector.

The second iteration, sketched out in a deal announced in Brussels on July 21, made some modest moves in the latter direction – and was praised by Ms Lagarde for showing Europe uniting to seize control of the situation – but it failed to impress the financial markets.

As much of the private sector in this context comprises western European banks, particularly French and German ones, it is all too easy for dissenters to construct an argument that a Europe-dominated IMF – despite reforms, a third of the votes on the fund's executive board are held by European countries, quite apart from the tradition of appointing a European managing director – is going easy on European countries and banks.

Indeed, in an unusual move in the usually discreet, not to say secretive, IMF, some emerging market representatives on the fund's board have openly criticised the Greek programme and said it would present a challenge to Ms Lagarde to distance herself from her European origins.

Ms Lagarde has dismissed those criticisms as "rubbish" and has distanced herself from European policymakers by warning that western European banks are likely to need more recapitalisation, a suggestion that arouses wrath at the ECB and the Commission.

But while the IMF has a legitimate advisory role on bank capital, its main business is crisis lending, and here Ms Lagarde may face a difficult decision about what to do with Greece.

The proposed comprehensive second rescue programme, which the July meeting envisaged having happened by now, is bogged down. Greece has failed to meet budget deficit targets under the current lending programme and those who were sceptical it would grow enough to claw itself out from under its debt burden have been vindicated.

The current indications are that Greece will receive the next tranche of lending under the programme after agreeing to impose a property tax to close a €2bn ($2.7bn) hole in its budget.

But unless growth picks up – and the higher taxes are set, the harder it becomes for the economy to expand quickly enough – it may soon become clear that Greece will need a huge amount of extra money and/or a substantial write-down in its sovereign debt.

This will not be an easy decision, not least because it may mean Ms Lagarde breaking with her European former counterparts, who are more likely to want to keep the money coming.

Ms Lagarde is a lawyer, not an economist – a fact that has raised eyebrows in the economics profession – and having the confidence to make a big call that turns on a judgment of the sustainability of a complex economic situation may involve almost as much boldness as disagreeing with fellow Europeans.

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